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Opinion of Advocate General at the Court of Justice of the European Union about the 'per element' approach

1. Introduction

On October 25, 2017 Advocate General (AG) Campos Sánchez-Bordona at the Court of Justice of the European Union (CJEU) published his Opinion on the preliminary ruling that the Dutch Supreme Court had requested in respect of two important corporate income tax cases, about which we had previously reported. The CJEU joined both cases as they have a common key issue, i.e. whether taxpayers, despite being unable to enter into a fiscal unity with subsidiaries established elsewhere in the EU, are nevertheless eligible for benefits from separate elements of the fiscal unity regime as if a fiscal unity with foreign subsidiaries can be entered into (the 'per element' approach).

In one of the cases, which concerns the interest deduction limitation (profit shifting, Section 10a Corporate Income Tax Act 1969; "CITA"), the AG concluded that the interest deduction limitation is contrary to the freedom of establishment. In response to this Opinion, the Cabinet announced – also on October 25, 2017 – emergency remedial measures. These will mean that, if the judgment by the CJEU has an undesirable budgetary impact for the Netherlands, some corporate income tax and dividend withholding tax rules – also in domestic relationships – will have to be applied as if there is *no* fiscal unity.

With regard to the other case, which involves the deduction of foreign exchange losses on EU participations, the AG concluded that there is no violation of EU law.

In the following sections, we address the Opinion in both cases as well as the Cabinet's response.

2. Profit shifting (Section 10a CITA)

As stated above, this case concerns an interest deduction that was refused. In simplified form, the case involved a Dutch company that borrowed from the Swedish top holding company of a group of which it was a member and then used the borrowed funds to make a share contribution in an Italian subsidiary, which, in turn, used these funds to delist another Italian group company. In dispute was the application of Section 10a CITA, given that this involved a loan from a related entity for the purposes of making a contribution in a related entity. One of the questions that arose was whether Section 10a CITA is contrary to EU law.

According to the Supreme Court, that is in principle not the case, but this could be different due to the overlap with the fiscal unity regime (the 'per element' approach). If the Italian subsidiary had been established in the Netherlands, then it could have been included in a fiscal unity with the Dutch company, in which case the contribution would not be a tainted transaction. The Supreme Court therefore requested a preliminary ruling from the CJEU in this case. The question posed to the CJEU was, in short, whether Section 10a CITA is contrary to the freedom of establishment in those cases where the application of that provision in national situations would be avoided by setting up a fiscal unity.

The Advocate General's Opinion
The AG firstly concluded that objectively similar cases are being treated differently here. The AG refers in this respect to the CJEU judgments in the X Holding and – to a lesser extent – the Groupe Steria cases. The question that then has to be asked is whether there is a justification for this, i.e. an overriding reason of public interest. The AG does not find sufficient support for this in the Supreme Court's referral ruling and in the comments by the Dutch government. According to the AG, the Dutch government's arguments were not detailed enough or were too general. However, a provision such as Section 10a CITA can indeed justify certain limitations being placed on the freedom of establishment, but according to the AG this argument is negated by the fact that the objective of the provision to combat tax evasion (to 'neutralize' the danger of erosion of the tax base) does not arise if – in domestic relationships – a fiscal unity is opted for. In short, the AG does not consider any overriding reasons of public interest to be present and draws the conclusion that Section 10a CITA is contrary to the EU freedom of establishment.

3. Foreign exchange losses on a UK participation

The other case concerned a Dutch parent company of a fiscal unity, which held direct and indirect participations, some of which were established in the UK. An interest in the Dutch company was held via this UK branch. Internal reorganizations took place in 2008 and 2009, which also involved intercompany debt. After the reorganizations, the Dutch company was held directly by the fiscal unity, while the UK branch was held indirectly via a Luxembourg company. As a result of the reorganizations a foreign exchange loss was incurred on the capital invested in the UK branch. The application of the participation exemption means that such foreign exchange losses are, in principle, non-deductible. The question that arose was whether EU law would nevertheless require their deduction.

The Supreme Court concluded that it is not beyond reasonable doubt whether the taxpayer is justified in invoking the Groupe Steria. It therefore requested a preliminary ruling from the CJEU. The questions posed to the CJEU are – freely translated –:

i. Does the EU freedom of establishment require that foreign exchange losses incurred on the capital invested in an EU subsidiary be deducted if this is also permitted in domestic situations?

If so, must:

ii. one or more of the indirectly held subsidiaries also be included in the fictive fiscal unity for the purposes of determining the foreign exchange loss, and
iii. the foreign exchange results from earlier years also be taken into account?

The Advocate General's Opinion
The AG begins by noting that in this case the foreign exchange results are directly related to the value of the shares and not to the result of the investments made by the subsidiary. He also notes that, in respect of the first question, he will focus on the loss in value upon the sale of the shares and, in respect of the third question, he will focus on the decline in value during the period the shares were held.

In answering the first question he concludes that an investment in a company established elsewhere in the EU is treated differently from an investment in a company established in the Netherlands that is included in a fiscal unity. In his view and with reference to the CJEU judgment in the X case, this different treatment is justified because in a participation situation any foreign exchange profits are also not taken into account.

In light of the answer to the first question, the AG only briefly addresses the second and third questions. He regards the second question as somewhat hypothetical and thus considers it inadmissible. With regard to the third question, he notes that it is up to the national court to examine whether, for the purposes of national tax law, the decline in value – apparently at the time the shares were held – qualifies as an actual economic loss that negatively affected the parent company's result.

The AG concluded that not allowing the deduction of foreign exchange losses incurred on EU subsidiaries is not contrary to the freedom of establishment.

4. Practical consequences: Cabinet response

Although the CJEU and the Supreme Court still have to render their final judgments on these cases, the Cabinet has already announced emergency remedial measures by way of a letter dated October 25, 2017, which will be taken, depending on the judgments in these cases. This is primarily due to the risk that those judgments, in light of the AG's Opinion in respect of Section 10a CITA, and the potential impact they will have on other elements of the fiscal unity regime, could lead to a considerable loss of tax revenue. After all, the more favorable treatment as a result of the consolidation in domestic situations, could then, per element, result in the same favorable treatment in similar EU situations. The Cabinet considers such an erosion of the tax base undesirable. The measures that have been announced mean that some corporate income tax and dividend withholding tax rules will have to be applied as if there is *no* fiscal unity. The rules mentioned in the Cabinet's response are the abovementioned Section 10a CITA, the participation exemption (with regard to the assessment of whether there is a qualifying investment participation, as well as the anti-hybrid measure), the deduction limitation for excessive participation interest, the loss set-off when there is a change of control and – with regard to dividend withholding tax rules – the remittance reduction for redistributions.

Should these emergency remedial measures appear necessary, they will have retroactive effect to 11:00 a.m. on Wednesday, October 25, 2017. The Cabinet

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concludes by noting that the emergency remedial measures will have to be followed in the near future by group rules that are future-proof. To ensure a good tax business climate, these rules will also be discussed with the business sector. Practical developments may mean that further (remedial) measures will be taken earlier than planned.

Meijburg & Co
October 2017